

## **ERC Disputes: Mastery of Procedural And Substantive Rules Required**

by Hale E. Sheppard

Reprinted from *Tax Notes Federal*, November 6, 2023, p. 977

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Hale E. Sheppard (hale.sheppard@chamberlainlaw.com) is a shareholder in the tax controversy section of Chamberlain, Hrdlicka, White, Williams & Aughtry in Atlanta.

In this article, Sheppard continues his discussion of employee retention credits and explores tricky procedural issues.

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## I. Introduction

A huge number of taxpayers have claimed employee retention credits in the past few years. Some might understand the dense substantive rules, but not many are likely to have knowledge about procedural nuances. This is problematic because a large percentage of clashes with the IRS ultimately turn on procedural issues.

After seeing repeated announcements by the IRS about its intention to recoup every dollar from improper ERCs, its expanded enforcement budget, and its recent training of personnel to carry out ERC examinations and investigations, astute taxpayers might raise the following questions: Has the IRS created special procedural rules for ERC cases? How long does the IRS generally have to audit ERC claims? Do extended assessment periods apply to claims for certain quarters? What examination techniques will the IRS use? What methods can taxpayers whose ERC claims are rejected or ignored use? Which courts will have jurisdiction over ERC litigation? Can the interplay between employment tax and income

tax cause taxpayers to get whipsawed by the IRS? This article, the latest in a series, explores these critical questions and others.<sup>1</sup>

## II. Main Congressional and IRS Guidance

Congress passed four laws in less than two years, and the IRS supplemented them by issuing multiple types of ERC guidance that provided direction for situations in which eligible employers claimed excessive ERCs.

### A. First Law

Congress enacted the Coronavirus Aid, Relief, and Economic Security Act in March 2020.<sup>2</sup> This article divides the initial law into two categories for ease of understanding.

#### 1. Overview of rules.

The CARES Act generally provided that an eligible employer could get an ERC against applicable employment taxes equal to 50 percent of the qualified wages that it paid to each employee for each quarter, subject to a maximum.<sup>3</sup>

<sup>1</sup>Readers seeking details about the ERC rules and their evolution should see the following articles by this author: Hale E. Sheppard, "Employee Retention Credits: Reasons for Prolonged Claims," *Tax Notes Federal*, Oct. 16, 2023, p. 431; "Employee Retention Credits: Issues Arise as Finger-Pointing Begins," *Tax Notes Federal*, Sept. 11, 2023, p. 1843; "IRS Clarifies Limited Eligibility of Federal Credit Unions for ERCs," *Tax Notes Federal*, Sept. 4, 2023, p. 1615; "New ERC Guidance About Suspended Operations and Supply Chains," *Tax Notes Federal*, Aug. 28, 2023, p. 1413; "Employee Retention Credits: Analyzing Key Issues for Promoters and Other Enablers," *J. Tax'n* (coming 2023); "Employee Retention Credits: Analyzing Key Issues for Taxpayers Facing IRS Audits," *J. Tax'n* (coming 2023); "Employee Retention Credits: Analyzing Congressional and IRS Guidance from Start to Finish," *J. Tax'n* (coming 2023).

<sup>2</sup>Joint Committee on Taxation, "Description of the Tax Provisions of P.L. 116-136, the Coronavirus Aid, Relief, and Economic Security Act," JCX-12R-20 (Apr. 23, 2020); see also Notice 2021-20, 2021-11 IRB 922.

<sup>3</sup>CARES Act, section 2301(a).

An eligible employer in this context meant one that was carrying on a trade or business and also met one of the following two tests. First, the employer's operations were partially or fully suspended during a quarter because of an order from an appropriate governmental authority that limited commerce, travel, or group meetings for commercial, social, religious, or other purposes because of COVID-19 (governmental order test).<sup>4</sup> Second, the employer suffered a significant decline in gross receipts during a particular quarter (reduced gross receipts test).<sup>5</sup>

The term "employment taxes" ordinarily refers to three items: (1) federal income taxes paid solely by employees through mandatory withholding by their employers, (2) amounts under the Federal Insurance Contributions Act, which are paid partly by employers and partly by employees, and (3) amounts under the Federal Unemployment Tax Act, which are paid entirely by employers.<sup>6</sup> The term "applicable employment taxes" generally meant FICA amounts for purposes of the CARES Act.<sup>7</sup>

The notion of qualified wages under the CARES Act depended on the number of full-time employees working for an eligible employer before things went downhill. There were two categories of employers: large and small. A large eligible employer had an average of more than 100 full-time employees, and qualified wages meant those paid to any employee who was not providing services as a result of the governmental order test or the reduced gross receipts test.<sup>8</sup> Alternatively, a small eligible employer had an average of 100 or fewer full-time employees, and qualified wages meant all wages paid during a quarter, whether or not the employees were actually working.<sup>9</sup> In addition, qualified wages

included the qualified health plan expenses paid by the eligible employer that were allocable to the qualified wages.<sup>10</sup>

Benefits were limited under the CARES Act. In particular, the amount of qualified wages for any one employee could not exceed \$10,000 for all applicable quarters combined in 2020. This meant that after applying the 50 percent limit, the maximum ERC per employee for 2020 in its entirety was \$5,000.<sup>11</sup>

Coverage of the ERC changed several times but it originally applied to qualified wages paid by eligible employers during the second, third, and fourth quarters of 2020.<sup>12</sup>

## 2. Treatment of excess ERCs.

The CARES Act said that the ERCs permitted for a particular quarter could not exceed the applicable employment taxes on the wages paid by an eligible employer for all employees for that quarter.<sup>13</sup> If the ERCs surpassed that threshold, the excess would be treated as an employment tax overpayment and refunded to the eligible employer under two provisions, sections 6402(a) and 6413(b).<sup>14</sup> Section 6402(a) provides that overpayments can be credited against any tax liability of the taxpayer that made the overpayment, with the remainder being refunded.<sup>15</sup> Section 6413(b) says that if more than the correct amount of employment taxes is paid or deducted, and the overpayment cannot be fixed via proper adjustments, it will be refunded to the taxpayer.<sup>16</sup>

Congress instructed the IRS to issue the forms, instructions, regulations, and other guidance necessary to allow for advance payments of ERCs to eligible employers and to require reconciliation of those payments when they later filed the relevant returns.<sup>17</sup> To implement this legislative mandate, the IRS revised various tax return forms, including Form 941, "Employer's

<sup>4</sup> *Id.* at section 2301(c)(2)(A)(ii)(I).

<sup>5</sup> *Id.* at section 2301(c)(2)(A)(ii)(II).

<sup>6</sup> Sections 3101, 3111, 3301, and 3401. When dealing with compensation paid to railroad employees and representatives, the term "employment taxes" also encompasses amounts imposed by the Railroad Retirement Tax Act. *See* section 3221.

<sup>7</sup> CARES Act, section 2301(c)(1). These consist of Social Security and Medicare taxes.

<sup>8</sup> *Id.* at section 2301(c)(3)(A)(i).

<sup>9</sup> *Id.* at section 2301(c)(3)(A)(ii)(I) and (II). Note that these standards later changed from 100 to 500 full-time employees. *See* Consolidated Appropriations Act, 2021, Division EE, section 207; and Notice 2021-23, 2021-16 IRB 1113, Section III.E.

<sup>10</sup> CARES Act, section 2301(c)(3)(C)(i).

<sup>11</sup> *Id.* at section 2301(b)(1); JCT, *supra* note 2, at 38.

<sup>12</sup> CARES Act, section 2301(m); *see also* Notice 2021-20.

<sup>13</sup> CARES Act, section 2301(b)(2).

<sup>14</sup> *Id.* at section 2301(b)(3)(A).

<sup>15</sup> Section 6402(b); reg. section 301.6402-1.

<sup>16</sup> Section 6413(b).

<sup>17</sup> CARES Act, section 2301(i)(1) and (2).

Quarterly Federal Tax Return,” and Form 941-X, “Adjusted Employer’s Quarterly Federal Tax Return or Claim for Refund,” so that eligible employers could use them to claim ERCs. Moreover, within just a few days of enactment of the CARES Act, the IRS published Form 7200, “Advance Payment of Employer Credits Due to COVID-19.”<sup>18</sup> It instructed eligible employers to “retain employment taxes” equal to their ERCs instead of depositing them with the IRS. If there were not enough applicable employment taxes to fully cover the ERCs claimed, taxpayers were told to complete and file a Form 7200 to seek advance payment from the IRS. Form 7200 offered the following example:

If an employer is entitled to an [ERC] of \$10,000 and was required to deposit \$8,000 in employment taxes, the employer could retain the entire \$8,000 of taxes as a portion of the refundable tax credit it is entitled to and file a request for an advance payment for the remaining \$2,000 using Form 7200.<sup>19</sup>

For second, third, and fourth quarters of 2020, no restriction existed on the type of eligible employers that could claim advance payments of ERCs from the IRS. There was no cap on the size of those payments, either, except that eligible employers first had to reduce employment tax deposits in anticipation of ERCs before seeking advance payments.<sup>20</sup>

## B. Second Law

Congress passed the Taxpayer Certainty and Disaster Tax Relief Act of 2020 in December 2020.<sup>21</sup> Again, this article divides the law into two parts.

### 1. Overview of rules.

As explained earlier, whether amounts paid by an eligible employer constitute qualified wages

depends in part on the average number of full-time employees. The relief act modified the standards for being a small eligible employer and a large eligible employer, thereby making it easier to claim ERCs for all wages paid to employees during certain quarters, not just to those who were not providing services.<sup>22</sup> In particular, large eligible employers became those whose average number of full-time employees was more than 500 (instead of more than 100), while small eligible employers were those with an average of 500 or less.<sup>23</sup>

The relief act also expanded the period during which eligible employers could benefit. They could claim ERCs not only for second, third, and fourth quarters of 2020 (as they could under the CARES Act), but also for first and second quarters of 2021.<sup>24</sup> Eligible employers could get increased amounts of ERCs, too. Under the CARES Act, an eligible employer could claim ERCs for only 50 percent of qualified wages, with a cap of \$10,000 per employee for all of 2020. Things changed in two ways thanks to the relief act. The figure increased from 50 percent to 70 percent of the qualified wages paid, and the amount was calculated per quarter, not per year. Thus, if an eligible employer were to pay an employee \$10,000 in qualified wages in each of the first and second quarters of 2021, the ERCs would total \$14,000 (that is, \$7,000 per quarter).<sup>25</sup>

### 2. Treatment of excess ERCs.

The relief act modified the rules when it came to advance payments of ERCs. It provided that only small eligible employers (using the newer definition) could seek them. It further said that those payments could not exceed 70 percent of the average quarterly wages paid by the eligible employer in 2019.<sup>26</sup> Moreover, the relief act established that if the advance payments received by a small eligible employer were greater than the

<sup>18</sup> IRS, “Instructions for Form 7200,” at 2 (Mar. 2020).

<sup>19</sup> *Id.*; see also Notice 2021-20, Section III, Question 50.

<sup>20</sup> Notice 2021-23, Section III.F.

<sup>21</sup> Consolidated Appropriations Act, Division EE, section 207; JCT, “Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security,” JCX-3-21, at 66-70 (Feb. 8, 2021); see also Notice 2021-23.

<sup>22</sup> Consolidated Appropriations Act, Division EE, section 207(e).

<sup>23</sup> Notice 2021-23, Section III.E.

<sup>24</sup> *Id.* at Section III.A.

<sup>25</sup> *Id.* at Section III.D.

<sup>26</sup> Consolidated Appropriations Act, Division EE, section 207(g)(1).

ERCs ultimately allowed for a quarter, then the applicable employment taxes would be increased by the excess.<sup>27</sup> These rules applied beginning first quarter of 2021.<sup>28</sup>

### C. Third Law

Congress introduced the American Rescue Plan Act in March 2021.<sup>29</sup> That law codified the ERC rules, making them section 3134 of the IRC.

ARPA expanded the ERC, allowing eligible employers to claim benefits for the third and fourth quarters of 2021.<sup>30</sup> Thus, at that point, the ERC was available for qualified wages paid during second, third, and fourth quarters of 2020 (under the CARES Act), first and second quarters of 2021 (under the relief act), and third and fourth quarters of 2021 (under ARPA).<sup>31</sup>

New section 3134 confirmed that surplus ERCs would be treated as overpayments by eligible employers, and credited or refunded to them, as appropriate.<sup>32</sup> New section 3134 also allowed for advance payments. It repeated that small eligible employers, according to the revised guidelines established in the relief act, could elect for any quarter to receive an advance payment of ERCs up to 70 percent of the average quarterly wages paid in 2019.<sup>33</sup> New section 3134 also corroborated that advance payments received by small eligible employers that surpassed the ERCs ultimately allowed would trigger an increase in applicable employment taxes.<sup>34</sup> Finally, new section 3134 directed the IRS to issue forms, instructions, regulations, and other guidance necessary to allow for advance payments of ERCs and “to prevent the avoidance of the purposes of the limitations” of section 3134.<sup>35</sup>

### D. Fourth Law

Things came to a close when Congress enacted the Infrastructure Investment and Jobs Act in November 2021.<sup>36</sup> That legislation announced the end of the ERC and it retroactively shortened the periods for claiming benefits. Eligible employers, with one narrow exception, could no longer solicit ERCs for fourth quarter 2021. As a result, ERCs for most eligible employers could not surpass a grand total of \$26,000, an amount consisting of \$5,000 for 2020 in its entirety, plus \$7,000 for each of the first, second, and third quarters of 2021. The IRS explained that advance ERC payments received by most small eligible employers for fourth quarter 2021 now constituted “erroneous refunds,” which had to be repaid.<sup>37</sup>

### III. Regulations on Recouping Excessive ERCs

Most taxpayers and advisers have been busy trying to get a grip on the substantive rules summarized above, which is no easy task. In doing so, they might have overlooked recent regulations about ERC procedural matters. These are examined below.

The IRS was obligated to issue two sets of temporary regulations because of the manner in which Congress introduced, and then modified, the ERC rules. The first set addressed the IRS’s recapture of improper ERC refunds issued to eligible employers under the CARES Act or the relief act.<sup>38</sup> The second set was necessary because ARPA created a new tax provision, section 3134, instead of simply expanding and amending the earlier laws.<sup>39</sup> The content of both sets of temporary regulations was very similar, and they were ultimately combined into just one set of final regulations.<sup>40</sup>

The temporary regulations remind taxpayers that ERCs were initially limited in several ways, one of which was that they could not exceed the applicable employment taxes on the wages paid

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at section 207(k).

<sup>29</sup> ARPA, section 9651; *see also* Notice 2021-49, 2021-34 IRB 316.

<sup>30</sup> ARPA, section 9651(a).

<sup>31</sup> *Id.*; *see also* section 3134(n).

<sup>32</sup> ARPA, section 9651(a); *see also* section 3134(b)(3).

<sup>33</sup> ARPA, section 9651(a); *see also* section 3134(j)(2)(A).

<sup>34</sup> ARPA, section 9651(a); *see also* section 3134(j)(3)(B).

<sup>35</sup> ARPA, section 9651(a); *see also* section 3134(m).

<sup>36</sup> P.L. 117-58; *see also* Notice 2021-65, 2021-51 IRB 880.

<sup>37</sup> Notice 2021-65, Section III.B.

<sup>38</sup> REG-111879-20; T.D. 9904.

<sup>39</sup> REG-109077-21; T.D. 9953, Section V.

<sup>40</sup> T.D. 9978; reg. section 31.3111-6; reg. section 31.3131-1; reg. section 31.3132-1; reg. section 31.3134-1; reg. section 31.3221-5.



for all employees of the eligible employer for the relevant quarter. If the ERCs topped this threshold, the excess would be treated as an overpayment and credited or refunded to the eligible employer, as appropriate. The temporary regulations emphasize, though, that a “refund, credit, or advance of any portion of [ERCs] to a taxpayer in excess of the amount to which the taxpayer is entitled is an erroneous refund for which the IRS must seek repayment.”<sup>41</sup> Likewise, the temporary regulations provide that “a refund or credit of any portion of [ERCs], regardless of whether they are advanced, to a taxpayer in excess of the amount to which the taxpayer is entitled is an erroneous refund that the employer must repay.”<sup>42</sup>

The temporary regulations further explain that section 6201 grants the IRS its general assessment authority. That provision broadly states that the IRS “is authorized and required to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to tax, and assessable penalties) imposed by” the IRC.<sup>43</sup> However, section 6201 does not expressly allow the IRS to assess any non-rebate portion of an erroneous refund of a refundable credit, like the ERC. Consequently, the government ordinarily recovers these amounts through voluntary repayment by the taxpayer or litigation.<sup>44</sup>

The temporary regulations, citing two decisions by the Supreme Court, clarify that the IRS has an unfettered right to engage in recoupment by trial: “The government can bring civil litigation to recover funds which its agents [including the IRS] have wrongfully, erroneously, or illegally paid, and no statute is necessary to authorize the government to sue in such a case, since the right to sue is independent of a statute.”<sup>45</sup> Still, the temporary regulations explain that the CARES Act and ARPA specifically contemplate “administrative recapture” of excess ERCs by authorizing the IRS to publish appropriate

guidance. The IRS carried out congressional instructions by issuing the temporary regulations. They grant the IRS authority to assess and collect improper ERCs, as follows:

These Temporary Regulations provide that erroneous refunds of [ERCs] are treated as *underpayments* of [applicable employment taxes] and authorize the IRS to assess any portion of the [ERCs] erroneously credited, paid, or refunded in excess of the amount allowed as if those amounts were tax liabilities . . . subject to assessment and administrative collection procedures.<sup>46</sup> [Emphasis added.]

Any amount of the [ERC] for Qualified Wages . . . that are erroneously refunded or credited to an employer shall be treated as *underpayments* of [applicable employment taxes] by the employer and may be administratively assessed and collected in the same manner as taxes.<sup>47</sup> [Emphasis added.]

The IRS offers several justifications for the temporary regulations. The most common is that the special procedures allow the IRS to efficiently recover unwarranted amounts and avoid the costs and burdens of litigation, while safeguarding administrative protections for taxpayers that dispute their tax liabilities.<sup>48</sup>

The temporary regulations clarify that they fortify, not substitute, the IRS’s normal tools. They state that “these assessment and administrative collection procedures *do not replace* the existing recapture methods, but rather represent an *alternative method* available to the IRS.”<sup>49</sup> (Emphasis added.)

The final regulations establish the following rule:

Any amount of credits for Qualified Wages . . . that is treated as an overpayment and refunded or credited to

<sup>41</sup> T.D. 9904, Section III.

<sup>42</sup> T.D. 9953, Section IV.

<sup>43</sup> Section 6201(a).

<sup>44</sup> T.D. 9953, Section V.

<sup>45</sup> T.D. 9904, Section IV.

<sup>46</sup> T.D. 9904, Explanation of Provisions.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*; T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

<sup>49</sup> T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

an employer [by the IRS] and to which the employer is not entitled, resulting in an erroneous refund to the employer, shall be treated as an *underpayment* of [applicable employment taxes] and may be assessed and collected by the [IRS] in the same manner as the taxes . . . The determination of any amount of credits erroneously refunded must take into account any amount of credits advanced to an employer under the process established by the [IRS].<sup>50</sup> [Emphasis added.]

#### IV. How and When Will ERC Battles Play Out?

Many taxpayers and their advisers are familiar with the procedures that apply in an income tax dispute. However, the ins and outs of employment tax battles, including those centered on ERCs, differ. As noted, a large percentage of tax tussles are won or lost on procedural issues, so understanding how ERC matters will be carried out is critical.

IRS disputes could arise in various ways, among them the following four. First, relying on the new procedures created by the final regulations, the IRS might conduct civil examinations of eligible employers that received credits or refunds, including advance payments. Second, the IRS might use a tool called administrative offset to take overpayments by eligible employers in one context and apply them to satisfy employment tax underpayments stemming from ERCs. Third, the Justice Department might follow the traditional path by filing erroneous refund lawsuits. Finally, shifting eligible employers from a defensive to an offensive role, another possibility is that eligible employers whose ERC claims were rejected or ignored by the IRS might file refund lawsuits.

#### A. Civil Examinations by the IRS

Logic dictates that many ERC showdowns will begin when revenue agents audit eligible entities that requested credits or refunds, received the benefits, and have open assessment periods. Readers first need a peek at timing.

<sup>50</sup> T.D. 9978; reg. section 31.3111-6(b) and (c); reg. section 31.3134-1(a) and (b); reg. section 31.3221-5(b) and (c).

#### 1. Deadlines.

Eligible employers could have solicited ERCs on timely Forms 941 for various quarters in 2020 and 2021. Alternatively, they could, and in some instances still can, seek ERCs by later filing Forms 941-X.

Forms 941 for all four quarters of a particular year are deemed filed on April 15 of the next year.<sup>51</sup> For example, Forms 941 for second quarter 2020 had to be filed by July 31, 2020, but were deemed to have been filed nearly nine months later, on April 15, 2021.<sup>52</sup>

A taxpayer normally must file a refund claim, including a Form 941-X, within three years after filing the relevant Form 941, or within two years after paying the relevant taxes, whichever period expires later.<sup>53</sup> Importantly, filing a refund claim does not create a new assessment period, and it generally does not extend the existing assessment period for the original Form 941.<sup>54</sup> The IRS has clarified this point in the employment tax context, explaining that “filing an amended Form 940 or an X Form (for example, Form 941-X) does not affect the period of limitations for assessment.”<sup>55</sup>

The IRS generally has three years from the date on which a tax return is filed (or deemed to have been filed) to identify it as problematic, conduct an audit, and propose changes.<sup>56</sup> Thus, the normal assessment period for Forms 941 for any quarter of 2020 will expire on April 15, 2024, while the standard assessment period for Forms 941 for 2021 will not end until April 15, 2025.<sup>57</sup> This shows that the IRS still has significant time to audit, even under the most restrictive time frame.

The rules further favor the IRS when it comes to ERC claims for third and fourth quarters of 2021.<sup>58</sup> ARPA granted the IRS more time to audit

<sup>51</sup> Section 6501(b)(2); reg. section 301.6501(b)-1(b); section 6513(c); reg. section 301.6513-1(c).

<sup>52</sup> Reg. section 301.6501(b)-1(b).

<sup>53</sup> Section 6511(a); reg. section 301.6511(a)-1(a); section 6511(b)(1); reg. section 301.6511(b)-1(a).

<sup>54</sup> *Badaracco v. Commissioner*, 464 U.S. 386, 393 (1984); IRS, “Employment Tax Returns — Examination and Appeals Rights,” Publication 5146, at 6 (rev. Mar. 2017).

<sup>55</sup> IRS, *supra* note 54.

<sup>56</sup> Section 6501(a).

<sup>57</sup> Reg. section 301.6501(b)-1(b).

<sup>58</sup> Notice 2021-49, Section III.G.

taxpayers that might be misbehaving. It gives the IRS five years, instead of three, from the date on which the relevant Form 941 is actually or deemed filed to challenge an eligible employer.<sup>59</sup> For instance, if an eligible employer filed a timely Form 941 for third quarter 2021 claiming ERCs, that Form 941 is deemed to have been filed on April 15, 2022, and the assessment period would stay open until April 15, 2027.

The IRS has repeatedly warned that many unscrupulous companies are urging taxpayers to take ERC positions that range from extremely aggressive to downright fraudulent.<sup>60</sup> The IRC provides that the IRS can assess taxes “at any time” in situations involving a false or fraudulent return.<sup>61</sup> Thus, the IRS might argue that assessment periods are endless for forms 941 and 941-X that are false, fraudulent, or designed to evade tax.

Eligible employers should thus be aware of the following time frames during which the IRS might audit and propose additional taxes and penalties:

- For ERC claims relating to second, third, and fourth quarters of 2020, the normal assessment period expires April 15, 2024.
- For ERC claims relating to first and second quarters of 2021, the normal assessment period expires April 15, 2025.
- For ERC claims relating to third and fourth quarters of 2021, the extended assessment period expires April 15, 2027.
- For ERC claims relating to any quarter in 2020 or 2021 that involves fraud or materially false statements, the assessment period never expires.

## 2. Summary of tax dispute process.

The final regulations indicate that improper ERCs that were credited or refunded to eligible employers will be treated as underpayments and assessed and collected by the IRS in the same manner as employment taxes.<sup>62</sup> Thus, one assumes that the IRS will use the following

procedure or a variation thereof. The IRS will initiate an audit of questionable forms 941 and 941-X. In light of the time limitations described above, revenue agents likely will ask eligible employers early in the process to voluntarily extend the applicable assessment periods by executing a Form SS-10, “Consent to Extend the Time to Assess Employment Taxes.” Whether eligible employers do so will depend on the circumstances. To the extent that revenue agents identify what they believe are undeserved ERCs, they will issue examination reports proposing tax liabilities and perhaps penalties. Eligible employers might challenge the examination reports by filing protest letters and seeking reconsideration by the Independent Office of Appeals. The IRS will only grant this administrative review, however, if ample time remains on the relevant assessment periods. Enter Form SS-10 yet again. Assuming that an eligible employer cannot reach an agreement with Appeals, the IRS will assess the taxes and penalties. This means that the IRS records a tax debt on its books, and collection actions can commence.

Eligible employers have a few potential remedies at this juncture. They can, for instance, wait for the IRS to issue a post-lien notice or pre-levy notice, file a request for a collection due process hearing, participate in a conference with Appeals, and then lodge a petition with the Tax Court to challenge an unfavorable notice of determination.<sup>63</sup> Alternatively, an eligible employer can pay the required amount and then file a refund suit with the proper district court or Court of Federal Claims.<sup>64</sup>

## B. Administrative Offsets by the IRS

The Internal Revenue Manual describes several types of erroneous refunds, one of which is when “a taxpayer submits an amended return

<sup>63</sup> Section 6330(c)(2)(B) (a taxpayer “may also raise at the hearing challenges to the existence or amount of the underlying tax liability for any tax period if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability”); reg. section 301.6330-1(e)(1); section 6330(d)(1); *Salazar v. Commissioner*, T.C. Memo. 2008-38.

<sup>64</sup> See IRS, *supra* note 54; IRM 4.23.4; American Bar Association Section of Taxation, *Effectively Representing Your Client Before the IRS*, Volume 1, Chapter 8 (2009); David M. Richardson et al., *Civil Tax Procedure*, Chapter 5 (2005).

<sup>59</sup> ARPA, section 9651(a); Notice 2021-49, Section III.G.

<sup>60</sup> See, e.g., IR-2021-65; IR-2022-183; IRS Tax Tip 2023-44; IR-2023-105.

<sup>61</sup> Section 6501(c)(1); reg. section 301.6501(c)-1(a).

<sup>62</sup> Reg. section 31.3111-6(b) and (c); reg. section 31.3134-1(a) and (b); reg. section 31.3221-5(b) and (c).



[like a Form 941-X] requesting a decrease in tax,” and the IRS allows it “even though the [IRS] makes only a hasty review of the return or inadvertently fails to screen the entire return to determine if the reduction in tax should be made.”<sup>65</sup> Various reports by governmental watchdogs indicate that this happened often, particularly in the early days of the ERC, because of insufficient staffing, unclear rules, and pressure on the IRS to get funds into the hands of struggling businesses as quickly as possible.<sup>66</sup> The good news for the IRS is that it might be able to exercise self-help in recouping amounts that it should not have released in the first place. As long as the IRS makes a timely assessment, it does not necessarily have to track down the eligible employer for payment. Rather, it can offset the liability by automatically applying tax overpayments by the eligible employer in other contexts.<sup>67</sup>

### C. Erroneous Refund Suits by the Government

The final regulations expressly say that the special ERC procedures supplement, not usurp, existing methods for recouping improper refunds issued to taxpayers.<sup>68</sup> This means that the government might opt for a traditional method — civil litigation. An erroneous refund of any portion of a tax imposed by the IRC, including employment taxes, can be recovered by a civil action by the government.<sup>69</sup> The government generally must initiate the lawsuit within two years after making the refund, although this period extends to five years “if it appears that any

<sup>65</sup> IRM 25.6.7.2.1.

<sup>66</sup> See Treasury Inspector General for Tax Administration, “Interim Results of the 2020 Filing Season: Effect of COVID-19 Shutdown on Tax Processing and Customer Service Operations and Assessment of Efforts to Implement Legislative Provisions,” Report No. 2020-46-041 (June 30, 2020); TIGTA, “Implementation of Tax Year 2020 Employer Tax Credits Enacted in Response to the COVID-19 Pandemic,” Report No. 2021-46-043 (July 9, 2021); TIGTA, “Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits,” Report No. 2022-46-059 (Aug. 31, 2022).

<sup>67</sup> Section 6402(b); reg. section 301.6402-1; reg. section 301.6402-3(a)(6). The IRS takes the position that the common law right of setoff applies to non-rebate erroneous refunds. See ILM 200014033.

<sup>68</sup> T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

<sup>69</sup> Section 7405(b).

part of the refund was induced by fraud or misrepresentation of material fact.”<sup>70</sup> As mentioned earlier, the IRS believes that many ERC claims are false or fraudulent, which means that the Justice Department might rely on the five-year period in bringing erroneous refund cases.

Here is an example. If an eligible employer timely filed Forms 941 for all four quarters of 2021, the law would treat them as being filed on April 15, 2022. That means that the eligible employer could file Forms 941-X claiming ERCs until April 15, 2025. Assume it did just that. Further assume that the IRS issued a refund on May 15, 2025, after only a cursory review. Finally, suppose that the IRS, after taking additional time to reflect, determined that the Forms 941-X filed by the eligible employer were fraudulent. In that case, the IRS would have five years from the payment date, until May 15, 2030, to file suit against the eligible employer to reclaim the erroneous refund.

### D. Refund Suits by Eligible Employers

Some taxpayers filed Forms 941 not claiming ERCs and paid all the normal employment taxes. They later learned about the opportunity, or Congress amended the law in their favor with retroactive effect. In those instances and others, taxpayers might have submitted Forms 941-X claiming refunds, yet they did not receive them. The IRS has no legal duty to respond to refund claims. This often shocks taxpayers. Practitioners, more resigned to procedural zaniness, describe this reality as follows: “If a refund claim is filed within the applicable statute of limitations, the IRS has the discretion to accept and pay the claim, to deny part or all of it, or to simply ignore it.”<sup>71</sup> Taxpayers rejected or snubbed by the IRS have one remedy; that is, to take the fight to the government.

The first step to recouping amounts from the IRS is for a taxpayer to file a timely refund claim.<sup>72</sup> A taxpayer normally must file a refund claim within three years of the time that he filed the relevant tax return, or within two years of the time

<sup>70</sup> Section 6532(b); reg. section 301.6532-2.

<sup>71</sup> Richardson et al., *supra* note 64, Chapter 9.

<sup>72</sup> Section 6511(a).

that he paid the relevant taxes, whichever period expires later.<sup>73</sup> When it comes to ERCs, Forms 941-X filed by eligible employers likely constitute refund claims.

If the IRS formally denies a refund claim by issuing a notice of disallowance, then the taxpayer can seek help from the courts by initiating a refund suit in the proper district court or Court of Federal Claims.<sup>74</sup> The taxpayer can also file a refund suit if the IRS simply ignores the taxpayer, failing to respond to the refund claim for at least six months.<sup>75</sup> Only district courts and the Court of Federal Claims, not the Tax Court, decide refund cases.<sup>76</sup>

## V. Potential Whipsaw of Eligible Employers

A term commonly used in tax disputes is “whipsaw.” It has several meanings, one of which is that the IRS takes two inconsistent positions, both unfavorable to a taxpayer, and only one can be correct. If the taxpayer does not recognize the threat and take timely steps to counter it, then it can get whipsawed by the IRS.<sup>77</sup> This concept might apply in the ERC context.

The CARES Act said that an eligible employer’s income tax deduction for the qualified wages it paid must be reduced by the amount of ERCs it receives.<sup>78</sup> A decrease in the wages-paid deduction might trigger an increase in the federal income tax liability.

The IRS, clarifying congressional standards, explained the following: “An employer’s deduction for Qualified Wages, including Qualified Health Plan Expenses, is reduced by the amount” of the ERC.<sup>79</sup> The IRS offered additional guidance on timing issues. The IRS presented the following scenario in which an eligible employer filed Forms 941-X to claim ERCs for earlier quarters after it had already filed its income tax return covering the same quarters:

When a taxpayer claims the [ERC] because of the retroactive amendment of [the law] or otherwise files [a Form 941-X] to claim the [ERC], the taxpayer should file an amended federal income tax return or administrative adjustment request (AAR), if applicable, for the taxable year in which the Qualified Wages were paid or incurred to correct any overstated deduction taken with respect to those same wages on the original federal tax return. [The CARES Act] generally provides, in relevant part, that rules similar to the rules of Section 280C(a) shall apply [and that provision] requires tracing to the specific wages generating the applicable credit. To satisfy this tracing requirement, the taxpayer must file an amended return or AAR, as applicable.<sup>80</sup>

The IRS warned that the situation has been exacerbated by the fact that some companies aggressively promoting ERCs fail to tell eligible employers that some benefits on the employment tax side (the receipt of credits and refunds) might cause detriments on the income tax side (increased liabilities) and that all the positions on related returns must be reconciled.<sup>81</sup>

Imagine a situation involving a calendar-year corporation that filed a Form 1120, “U.S. Corporation Income Tax Return,” for 2021, and later filed a timely Form 941-X for third quarter of 2021 claiming significant ERCs, which would be deemed filed on April 15, 2022. The corporation received the refund requested. Soon thereafter, based on instructions from the IRS, the corporation filed a Form 1120-X, “Amended U.S. Corporation Income Tax Return,” to reduce the wages-paid deduction for 2021. This triggered an additional income tax liability, which the corporation quickly paid. Years pass with no contact by the IRS. Eventually, the IRS starts an audit of the corporation’s ERC claim, concludes that it was unjustified, and assesses employment taxes on June 1, 2026. The IRS can assess on that date (which was well after the normal three-year period) thanks to the extended five-year period

<sup>73</sup> Section 6511(a); reg. section 301.6511(a)-1(a).

<sup>74</sup> Section 6532(a)(1); reg. section 301.6532-1(a); section 7422(a).

<sup>75</sup> Section 6532(a)(1); reg. section 301.6532-1(a); section 7422(a).

<sup>76</sup> 28 U.S.C. section 1346(a)(1).

<sup>77</sup> See generally Havey S. Gilbert et al. “Whipsaw Revisited,” 43(2) *Tax Law*. 343 (Winter 1990); IRM 5.20.6; IRM 8.2.3.13.

<sup>78</sup> CARES Act, section 2301(e).

<sup>79</sup> Notice 2021-20, Section II.F.; Notice 2021-20, Section III.K., Question 60.

<sup>80</sup> Notice 2021-49, Section IV.C.

<sup>81</sup> IR-2022-183.

created by ARPA and section 3134. After a deeper analysis of the issue, the corporation concedes that it was wrong, that it never really met the standards to obtain ERCs, and that it had been misled. It is not all bad news, thinks the corporation, because it can go back and file another Form 1120-X to increase the wages-paid deduction to reflect the disallowed ERCs. This would cause an income tax overpayment for 2021 and thus a refund, right? Wrong. Unless the corporation filed a timely protective Form 1120-X contemplating the potential ERC disallowance and its effect on the wages-paid deduction, it might be out of time, and out of luck. In other words, it might have been whipsawed by the IRS.

This example should have eligible employers and their advisers thinking about the interplay of employment tax and income tax issues in the ERC context, as well as whether filing protective amended income tax returns is an option or a must.<sup>82</sup>

## VI. Conclusion

The substantive ERC rules are complicated, opaque, and derived from multiple sources issued by Congress and the IRS. This article shows that the procedural ERC rules can be daunting, too. Given this reality and the serious amount of money at stake in many cases, eligible employers would be wise to gather all materials supporting their claims, hire counsel with proven knowledge of both substantive and procedural ERC issues, and prepare for the likelihood of an IRS encounter, one way or another. ■

<sup>82</sup> See generally ILM 200547011; Burgess J.W. Raby and William L. Raby, "Protecting the Protective Refund Claim," *Tax Notes*, Apr. 28, 2003, p. 529; IRM 21.5.3.4.7.3; Kristy M. Bowden, "Protective Claims for Refund: Protecting the Interests of Taxpayers and the IRS," 56 *Me. Law Rev.* 149 (2004); Brian T. Whitlock, "Protective Claims Abound as Supreme Court Reviews ACA," 98(10) *Taxes* 23 (2020).

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